From: Roberts, Ryan
Sent: Wednesday, July 21, 2004 8:31 PM
To: George, Gregory L
Subject: RE: slides
Attachments: PR restructure glg revised 0721041 rkr.ppt

Here is the updated slides.

> -----Original Message-----
>From: George, Gregory L
>Sent: Wednesday, July 21, 2004 11:14 AM
>To: Roberts, Ryan
>Subject: slides
>Importance: High
>
> << File: PR restructure glg revised 0720041 rkr.ppt >>
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Government Exhibit
8

Microsoft®

Planning Alternatives in Puerto Rico

July 21, 2004

Brett Weaver
Greg George
Steve Lainoff
Manal Corwin
KPMG - Seattle

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1

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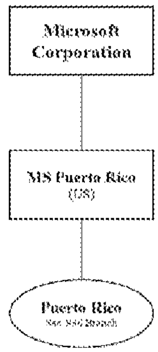
Current Structure

• Microsoft Puerto Rico ("MS Puerto Rico") currently manufactures CDs through a branch operating in Puerto Rico ("PRB").

• Current US tax benefit is based on Sec. 936 regime, which phases out completely in 2005.

•As a result of the phase-out, Microsoft should explore US deferral opportunities taking advantage of the existing manufacturing operations in Puerto Rico



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Continuing Operations in Puerto Rico - Advantages

Continuing operations in Puerto Rico may yield certain advantages:

- Offshore manufacturing in PR for the US market isolates tax risks from profits deferred elsewhere
- US tax deferral may partially offset foregone Sec. 936 tax credit
- Few operational changes required
- Microsoft gains expertise in deferral strategies for the US market

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Continuing Operations in Puerto Rico – Key Issues

- Operational Considerations
  - This presentation assumes that a status-quo approach was preferable
- Cost Sharing Arrangement
  - MSPR manufactures only a portion of the CDs for FPP, Select and EA's in the America's
  - As such, a cost sharing arrangement by product or geography will not be possible without significant operational changes
  - MS may consider an arrangement with a minimum and maximum purchase order commitment
    - Should meet arms-length requirements under cost sharing regulations
    - Achieves desired result without operational changes
    - Commitment may be viewed as a separate asset
  - MSPR free to sell product to both related and unrelated

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Continuing Operations in Puerto Rico – Key Issues

- Subpart F
  - In order to meet manufacturing exception, will need to specifically identify products sold which are manufactured in Puerto Rico
    - No longer able to use ratios to approximate sales (issues with Select/EA?)
  - Address manufacturing branch issues with proposed structures
- ECI/US trade or business
  - MS continues to own third-party contract manufacturing
  - MS is IPCo's only known customer
- Anticipated revised buy-in regulations
  - Proposed regulations expected by month's end
  - Impact on timing

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Continuing Operations in Puerto Rico – Key Issues

- Avoiding the Sec. 2(j) PR tax penalties
  - Generally can be avoided with proper planning
  - May also transition to 1022(b)(4) investments without penalty
- Structure
  - Operational efficiency
  - Effective tax rate
  - Exit strategy

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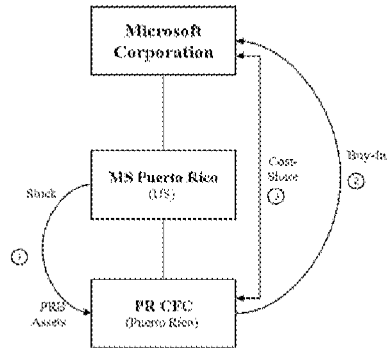
Proposed Structure 1 – Puerto Rico CFC

Steps

1. MS Puerto Rico (or MS Corp) contributes the assets of PRB tax-free to a new Puerto Rico company, PR CFC, in exchange for stock.
2. PR CFC buys-in to the existing technology intangibles with respect to the software products that it manufactures.
3. PR CFC and MS Corp enter into a cost-share arrangement with respect to future developed intangibles.
4. PR CFC may either adopt the existing tax arrangement, or apply for a new agreement with the Puerto Rican taxing authorities for a tax holiday in Puerto Rico. PR CFC should be taxed on its profits in Puerto Rico at a rate of 2% to 7%, depending on size of operations and profit projections, for a period of 10 to 20 years.



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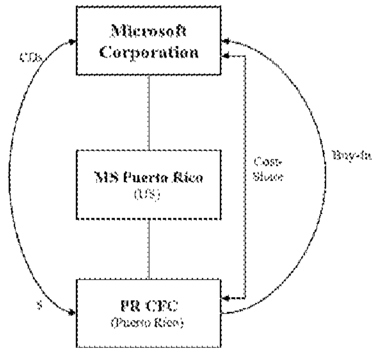
Proposed Structure 1 – Puerto Rico CFC, cont.

Benefits

- No operational changes as PR CFC continues to operate its manufacturing operations as PRB did under Sec. 936 regime.
- Cost share payment should be deductible against PR CFC's income for Puerto Rican purposes, and may qualify for special deduction status which would allow for a double deduction on payments made.
- PR CFC sells CDs to MS Corp. MS Corp continues to use contract manufacturers for final production into FPP, Select and EA

Issues

- Buy-in royalties subject to Puerto Rican withholding tax. Could likely get the 10 percent rate reduced to 2 percent.
- Exit would likely result in tax on the FMV of PR CFC at the IDI rate (2-7 percent).
- Would need to decide whether to leave 2(j) investments at MSPR, or transfer them to PR CFC Transfer can be negotiated with Puerto Rican government and will likely result in no current gain recognition, as well as a carry forward of MS Puerto Rico's holding period to PR CFC.



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Proposed Structure 1 – Puerto Rico CFC, cont.

Hypothetical P&L

(in '000s)	*Without Structure* MS Corp	*With Structure* MS Corp	*With Structure* PR Newco	Elimination	Total
Revenue	100	100	47	(47)	100
COGS	(5)	(47)	(5)	47	(5)
Gross Profit	95	53	42		95
Sales and Marketing	(20)	(20)	-		(20)
SG&A	(10)	(10)	-		(10)
R&D	(20)	-	(20)		(20)
Cost Reimbursement	-	-	-		-
Total Expense	(50)	(30)	(20)		(50)
Total Income	45	23	22		45
Effective Tax Rate	35.00%	35.00%	2.00%		18.87%
Tax	16	8.05	0.44		8.49

Total Profit	45
Routine Profit	(5)
Residual Profit	40
Tech IP	20
Mark IP	20

Assumptions:

Routine profit is 5 percent

Residual profit is split 50/50 between Tech and Mark IP

ETR benefit shown is post buy-in

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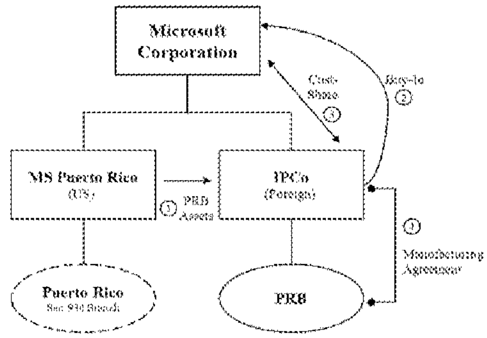
Proposed Structure 2 – IPCo with Puerto Rico Branch

Steps

1. PRB assets contributed/sold to IPCo.
2. IPCo buys-in to the existing technology intangibles with respect to the software products that PRB manufactures.
3. IPCo and MS Corp enter into a cost-share arrangement with respect to future developed intangibles.
4. IPCo and PRB enter into a cost-plus arrangement for manufacturing of CDs. (PRB will likely be held by a disregarded subsidiary of IPCo).
5. MS Corp and PRB enter into an agreement with the Puerto Rican taxing authorities for a tax holiday in Puerto Rico. If qualified, PRB should be taxed on its profits in Puerto Rico at a rate of 2% to 7%, depending on size of operations, for a period of 10 to 20 years.



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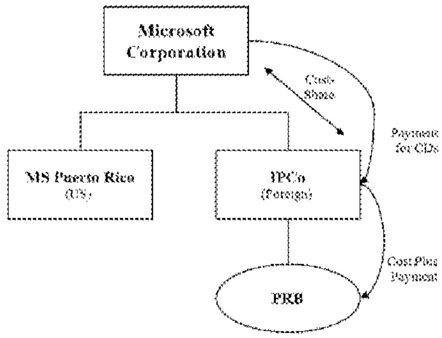
Proposed Structure 2 – IPCo with Puerto Rico Branch, cont.

Benefits

- No operational changes as PRB continues to operate its manufacturing operations as PRB did under Sec. 936 regime.
- No withholding tax issues on buy-in royalty, dividends, etc. out of IPCO.
- No exit tax from IPCo if MS decides to unwind structure.
- No tax holiday sunset or negotiations needed at IPCo if located in tax haven.

Issues

- Structure asset migration as tax-free for US and PR tax purposes
- Will need a PR tax ruling for transfer of assets to PRB to ensure tax-free treatment (with upcoming elections, would need to apply in next 2 months to ensure answer prior to regime change).
- Manufacturing branch issue – need to have ETR of IPCo be less-than 5 percentage points of PRB ETR.
- Would need to decide whether to leave 2(j) investments at MSPR, or transfer them to PR CFC. Transfer can be negotiated with Puerto Rican government and will likely result in no current gain recognition, as well as a carry forward of MS Puerto Rico's holding period in PR CFC.



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Proposed Structure 2 – IPCo with Puerto Rico Branch, cont.

Hypothetical P&L

(in 000s)	*Without Structure*	*With Structure*				
	MS Corp	**MS Corp**	**IPCo**	**PRB**	**Elimination**	**Total**
Revenue	100	100	47	6	(53)	100
COGS	(5)	(47)	(6)	(5)	53	(5)
Gross Profit	95	53	41	1		95
Sales and Marketing	(20)	(20)	-	-		(20)
SG&A	(30)	(30)	-	-		(30)
R&D	(20)	-	(20)	-		(20)
Cost Reimbursement	-	-	-			-
Total Expense	(50)	(30)	(20)	-		(50)
Total Income	45	23	21	1		45
Tax Rate	35.00%	35.00%	0.00%	5.00%		18.00%
Tax	16	8.05	0	0.05		8.10

Assumptions:

Total Profit	45	
Routine Profit	(5)	Routine profit is 5 percent.
Residual Profit	40	Residual profit is split 50/50 between Tech and Mark IP
Tech IP	20	ETR benefit shown is post buy-in
Mark IP	20	Cost plus 20 percent on manufacturing function

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12

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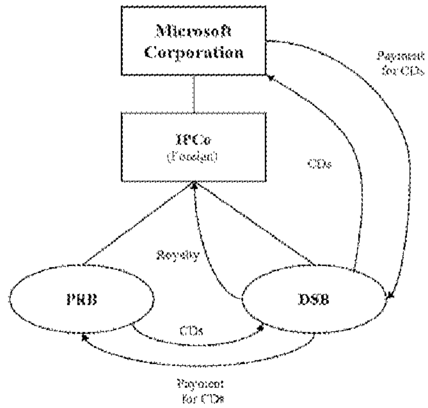
Proposed Structure 3 – IPCo with Puerto Rico Branch & Dutch Sales Branch

Steps

1. PRB assets contributed/sold to IPCo.
2. IPCo buys-in to the existing technology intangibles with respect to the software products that PRB manufactures.
3. IPCo and MS Corp enter into a cost-share arrangement with respect to future developed intangibles.
4. IPCo and PRB enter into a cost-plus arrangement for manufacturing of CDs. (PRB will likely be held by a disregarded subsidiary of IPCo).
5. MS Corp and PRB enter into an agreement with the Puerto Rican taxing authorities for a tax holiday in Puerto Rico. If qualified, PRB should be taxed on its profits in Puerto Rico at a rate of 2% to 7%, depending on size of operations, for a period of 10 to 20 years.
6. IPCo establishes a Dutch sales branch ("DSB") in the Netherlands and with transfer pricing ruling on spread left behind.



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13

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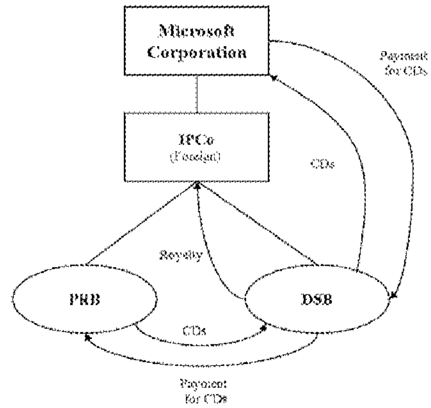
Proposed Structure 3 – IPCo with Puerto Rico Branch & Dutch Sales Branch

Benefits

- Gives position to avoid manufacturing branch issue if the ETR delta between PRB and IPCo is greater than 5 percent.
- Minimal operational changes required with sales function moving to DSB.
- No withholding tax issues on buy-in royalty, dividends, etc. out of IPCO.
- No exit tax from IPCo if MS decides to unwind structure.
- No tax holiday sunset or negotiations needed at IPCo if located in tax haven.

Issues

- Will need a tax ruling for transfer of assets to PRB to ensure tax-free treatment (with upcoming elections, would need to apply in next 2 months to ensure answer prior to regime change).
- Quantify risk associated with the manufacturing branch issue.
- Would need to decide whether to leave 2(j) investments at MSPR, or transfer them to PR CFC. Transfer can be negotiated with Puerto Rican government and will likely result in no current gain recognition, as well as a carry forward of MS Puerto Rico's holding period to PR CFC.



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Proposed Structure 3 – IPCo with Puerto Rico Branch & Dutch Sales Branch, cont.

Hypothetical P&L

(in 000s)	*Without Structure*	*With Structure*					
	MS Corp	MS Corp	IPCo	P&B	DSB	Elimination	Total
Revenue	100	100	40	6	17	(63)	100
COGS	(5)	(47)	-	(5)	(6)	58	-
Gross Profit	95	53	40	1	11		135
Sales and Marketing	(20)	(20)	-	-	-		(20)
SG&A	(10)	(10)	-	-	-		(30)
R&D	(20)	-	(20)	-	-		(20)
Royalty Expense	-	-	-	-	(40)		
Cost Reimbursement	-	-	-	-	-		-
Total Expense	(50)	(30)	(20)	-	(40)		(90)
Total Income	45	23	20	1	1		45
Tax Rate	35.00%	35.00%	0.00%	5.00%	35.00%		18.00%
Tax	16	8.05	0	0.05	0.35		8.10

Total Profit	45	
Routine Profit	(5)	
Residual Profit	40	
Tech IP	20	
Mark IP	20	

Assumptions

Routine Profit is 5 percent
Residual profit split 50/50 between Tech and Mark IP
ETR benefit is post buy-in
Cost plus 20 percent on manufacturing function

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15

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Other Alternatives

1. Cost Share technology <u>and</u> marketing intangibles
   - Requires significant operational changes
   - Increases overall benefit

2. Consider non-qualified cost sharing techniques
   - New cost sharing and upcoming buy-in regulations can make alternative structures more beneficial
     - Partnership techniques
     - Non-qualified cost sharing arrangements
     - Other

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KPMG Team

- The KPMG team has significant experience in assisting Fortune 50 companies in the migration of Section 936 company assets to new deferral structures in several industries including technology, pharmaceuticals, and consumer products.
- Brett Weaver and Greg George will lead the local team and co-ordinate all aspects of the project.
- National resources committed to this project include Steve Lainoff, a principal in KPMG's National Tax practice, as well as Ron Harvey and Ed Kennedy, principals in KPMG's New York office with extensive experience in migrations of this kind.
- The Puerto Rican team will be led by Rolando Lopez, a partner in the San Juan office who has previously advised several U.S. clients on migrations of this type and successfully negotiated significant tax holidays for U.S. companies with the Puerto Rican government.

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